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1 I'm 95-percent certain I never mentioned this
2 data request. I could be wrong but -- I asked questions
3 about 1984 capital stock, I asked questions about the
4 TPIs and --

5 MR. SASSER: Your Honor, my notes and my
6 colleagues' notes both reflect Data Request 5 was the
7 questions that were asked.

8 MR. FABER: I won't object, your Honor. That's
9 fine.

10 ALJ REED: Okay.

11 MS. SASSER: Q Dr. Christensen, Data Request 5
12 references the February 3rd, 1995 ex parte filing and
13 asked for an identification of which items shown on
14 pages 2 and 3 of that filing were in the nature of
15 corrections and errors.

16 It then goes on to ask for the items
17 identified as errors, indicate how the errors were
18 discovered, who discovered it, when it was discovered,
19 who corrected it, and when the corrections were provided
20 to USTA and/or to Dr. Christensen.

21 Do you know what process the LECs followed in
22 discovering the errors?

23 A No.

24 Q Is the statement that, "Dr. Christensen does
25 not know how the errors were discovered," accurate in
26 your opinion?

27 A Yes.

28 Q Do you know who discovered the errors?

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1 A No.

2 Q Do you know when they were discovered?

3 A No.

4 Q And do you know who corrected them?

5 A No, I do not.

6 MR. SASSER: Thank you.

7 I have nothing further, your Honor.

8 ALJ REED: Thank you, counsel.

9 Ms. Burdick, in her question and request for
10 some information to be provided in response, brought to
11 mind something that I think will make for some
12 efficiency, and that is if I can get a feel from each of
13 you of how many exhibits, of various information you've
14 requested, is going to take up, tentatively we can
15 assign them a number and then that information will
16 appear in the proper area, close to Dr. Christensen's
17 testimony and other information.

18 MR. FABER: Your Honor, specifically my questions
19 were for the workpapers and supporting TPI documents
20 that are referenced in Request 6, Request 7 and
21 Request 8 in Exhibit No. 8.]

22 So that would be 3. And I think we could mark
23 each of the sets of documents that came in response to
24 that as a separate exhibit, and that would be perfectly
25 fine.

26 ALJ REED: Okay. So tentatively I will assign
27 those Exhibit Nos. 10, No. 11, and No. 12 for
28 identification.

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1 ALJ REED: Okay. Thank you.

2 MR. GOLABEK: Your Honor, on that particular
3 document, I think it's -- he referred during his
4 questioning to page 12 of 18 or 13 of 18. If we don't
5 leave room for it in the record, it may muck up
6 the record.

7 MR. FABER: The one in Exhibit 8 that we're going
8 to pull out is in regard to Data Request No. 2 and
9 the response. I've only referred to those things
10 by means of a data request.

11 MR. GOLABEK: You also have referred to them --
12 at least it was for one of them -- as page something of
13 18, which came up in the record.

14 MS. BURDICK: That was Exhibit 9.

15 MR. FABER: That was Exhibit 9.

16 Would you like me to redo Exhibit 9 and have
17 page numbers as well?

18 MR. GOLABEK: I know you referred to some things
19 as page 12 of 18. It's on the record as 12 of 18
20 and you won't have that enumerated on Exhibit 9
21 if you pull the pages.

22 MR. FABER: For that -- in fact, I do. It's
23 Exhibit 8; it's at the very top. It's at the fax header
24 for Pacific Bell.

25 MR. GOLABEK: You're going to create blank headers
26 for those pages?

27 MR. FABER: I'll just delete those from the
28 document; I won't renumber them for Exhibit 8.

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1 I see what you're saying. They'll retain the fax header
2 if there's a reference to page 18. They'll still say
3 Exhibit 8.

4 ALJ REED: Okay. With that amendment, or editing
5 of those particular pages, are there any objections?

6 (No response)

7 ALJ REED: Exhibits 8 and 9 are moved into
8 evidence.

9 (Exhibit Nos. 8 and 9 were received
10 into evidence.)

11 MR. FABER: Thank you, your Honor.

12 ALJ REED: Thank you, Dr. Christensen.

13 MR. CHRISTENSEN: Thank you.

14 ALJ REED: Mr. Sasser, you have at least
15 ten minutes. Do you want to get your next witness
16 sworn in, or perhaps do some other preliminary stuff.

17 MR. SASSER: That will be fine, your Honor,
18 and Mr. Castle will be presenting the next witness.

19 ROBERT G. HARRIS, called as a witness by
20 Pacific Bell, having been sworn, testified as
follows:

21 ALJ REED: Please be seated.

22 Would you state your name, spelling your last
23 name, and give your business address for the record.

24 THE WITNESS: Okay. It's Robert G. Harris,
25 H-a-r-r-i-s,. And my business address is 2000 Powell
26 Street, P-o-w-e-l-l, Room 600, Emeryville,
27 California, 94608.

28 ALJ REED: Mr. Castle.

1 SAN FRANCISCO, CALIFORNIA, SEPTEMBER 26, 1995 - 9:15 AM

2 * * * * *

3 ADMINISTRATIVE LAW JUDGE REED: On the record.

4 This is the time and place set for the
5 investigation of 95-05-047 on the Commission's own
6 motion into the Second Triennial Review of the
7 Operations and Safeguards of the Incentive-Based
8 Regulatory Framework for Local Exchange Carriers.

9 Good morning.

10 MR. GOLABEK: Good morning, your Honor.

11 VOICES: Good morning.

12 ALJ REED: My name is Jacqueline Reed, and this
13 morning we are going to be starting with Pacific Bell's
14 witnesses.

15 Before we start with Dr. Schmalensee --

16 MR. SASSER: Schmalensee.

17 ALJ REED: -- Dr. Schmalensee, I noted that there
18 was a request that we get some of our dates certain on
19 the record to sort of remind us what days have been
20 reserved. And those -- I have this all written down. I
21 am going to let you all tell me again what days you have
22 requested your witnesses to appear.

23 Mr. Castle and Mr. Sasser?

24 MR. SASSER: Thank you, your Honor.

25 Yes. We had requested a date certain of
26 today, September 28th, for Dr. Schmalensee. He would be
27 followed by Dr. Christensen, and thereafter by
28 Dr. Harris, who we had requested a date of tomorrow,

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1 September 27th. I think I misstated today as September
2 28th.

3 ALJ REED: Right. Okay. Thank you.

4 ALJ REED: And, Mr. Brown?

5 MR. BROWN: Yes, your Honor.

6 MCI requested a date certain of September 28th
7 for Dr. Nina Cornell.

8 ALJ REED: Okay. Thank you. And Mr. Phillip?

9 MR. PHILLIP: Yes, your Honor.

10 CCTA had requested October 5th as the day for
11 presentation of Dr. Collins and Dr. Wolak.

12 ALJ REED: Okay.

13 MR. GOLABEK: Good morning, your Honor.

14 GTE had requested a date certain of October
15 2nd for Professor Sappington who will testify on behalf
16 of GTE.

17 And GTE would just like note for the record
18 that the only date we had trouble with for Mr. McCallion
19 was October 2nd.

20 And we'll have Dr. Duncan available any time
21 on the first four days here.

22 ALJ REED: Okay. Mr. --

23 MR. FABER: Thank you, your Honor.

24 We have requested that the day of Friday the
25 6th of October be reserved for Dr. Selwyn's testimony.

26 ALJ REED: And, Ms. Grau, we had said that
27 somewhere in the midst of all of that your witnesses
28 would be in there.

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1 MS. GRAU: Exactly. And our concern was that it
2 would not be truly in the midst of all of that. We were
3 anticipating from the way the schedule went that we
4 would be testifying next week.

5 ALJ REED: Okay.

6 MR. STOVER: (Indicating)

7 ALJ REED: Yes, sir?

8 MR. STOVER: And for AT&T, your Honor --

9 ALJ REED: Uh-huh?

10 MR. STOVER: -- we had requested that Dr. Mayo be
11 permitted to testify on the 6th of October.

12 ALJ REED: Okay. Thank you, Mr. Stover.

13 One thing that I didn't take care of while we
14 were off the record was the order that we are going to
15 proceed in.

16 For a moment, off the record.

17 (Off the record)

18 ALJ REED: On record.

19 Off the record I was getting the order of
20 parties to cross-examine the witnesses.

21 For the 6th position I have sketched in
22 Mr. Golabek's name.

23 And Mr. Stover brought up a concern that,
24 given our limited time, there is not going to be an
25 encouragement of friendly cross during this proceeding,
26 and I think that generally that's understood by the
27 companies, and Mr. Golabek asked that that also be
28 extended in terms of the Coalition.

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1 We do have a limited amount of time, and so I
2 would ask that that not occur.

3 Mr. Sasser has asked if we can come up with
4 some estimates for the length of time of
5 cross-examination for his two witnesses, Dr. Schmalensee
6 and Dr. Christensen.]

7 I will start with you, Mr. Faber. Do you
8 have -- I know you are not going to be doing
9 Dr. Christensen until --

10 MR. FABER: I would anticipate having between one
11 and two hours for Mr. Schmalensee. It will depend of
12 course on the nature of the answers that I get to my
13 questions. But that is a reasonable estimate.

14 As far as Dr. Christensen, I would estimate
15 the same.

16 ALJ REED: Okay.

17 Ms. Burdick and Mr. Phillip?

18 MS. BURDICK: Schmalensee, I would expect to have
19 about an hour. And for Dr. Christensen, about the
20 same.

21 ALJ REED: Mr. Brown?

22 MR. BROWN: Your Honor, I would anticipate for
23 Dr. Schmalensee no more than 10, maybe 15 minutes. That
24 will depend on, obviously, the questions that are asked
25 by the other counsel.

26 ALJ REED: Okay.

27 Mr. Stover.

28 MR. STOVER: Your Honor, I would have maximum of

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1 around 20 minutes for Mr. Schmalensee and at this time
2 nothing for Dr. Christensen.

3 ALJ REED: Ms. O'Reilly?

4 MS. O'REILLY: On the unlikely assumption that none
5 of my questions will have been asked by the previous
6 attorneys, I would have about 20 minutes to half an hour
7 for each of these witnesses.

8 ALJ REED: Thank you.

9 ALJ REED: Mr. Golabek, since you probably are not
10 going to have any, we will move right along.

11 Ms. Grau?

12 MS. GRAU: Ten minutes for Dr. Schmalensee and half
13 hour to 45 minutes for Dr. Christensen.

14 ALJ REED: Thank you.

15 Half hour later, but let us begin.

16 MR. SASSER: Pacific Bell calls Dr. Richard
17 Schmalensee to the stand.

18 ALJ REED: Good morning, Dr. Schmalensee.

19 RICHARD LEE SCHMALENSEE, called as a
20 witness by Pacific Bell, having been sworn,
testified as follows:

21 ALJ REED: Please be seated. Would you state your
22 name, your business address, spelling your last name,
23 please.

24 THE WITNESS: My name is Richard Lee Schmalensee,
25 S-c-h-m-a-l-e-n-s-e-e. My business address is 1 Main
26 Street, Cambridge, Massachusetts, 02142.

27 ALJ REED: Okay. Mr. Sasser.

28 MR. SASSER: Your Honor, on September 8th, Pacific

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1 Bell distributed to your Honor and all parties in this
2 proceeding a document entitled "The Prepared Testimony
3 of Dr. Richard L. Schmalensee Before the Public
4 Utilities Commission of the State of California on
5 Behalf of Pacific Bell, Investigation No. 95-05-047,
6 September 8th, 1995." May I have a copy of that
7 document marked first in order.

8 ALJ REED: It will be marked for identification as
9 Exhibit No. 1.

10 (Exhibit No. 1 was marked for
11 identification.)

12 MR. SASSER: In addition, Pacific Bell distributed
13 to all parties in this proceeding on September 18th,
14 1995 a document entitled "Prepared Reply Testimony of
15 Dr. Richard L. Schmalensee Before the Public Utilities
16 Commission of the State of California on Behalf of
17 Pacific Bell, Investigation No. 95-05-047,
18 September 18th, 1995." May I have a copy of that
19 document marked next in order.

20 ALJ REED: That will be marked for identification
21 as Exhibit No. 2.

22 (Exhibit No. 2 was marked for
23 identification.)

24

25 DIRECT EXAMINATION

26 BY MR. SASSER:

27 Q Dr. Schmalensee, do you have a copy of
28 Exhibit 1 for identification before you?

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1 A Not immediately, but yes.

2 Q Was Exhibit 1 prepared by you or under your
3 direction?

4 A Yes, it was.

5 Q Do you have any additions or corrections to
6 make to Exhibit 1?

7 A Yes, I have some corrections to make to
8 Exhibit 1, four, I believe. Shall I just read them?

9 Q Yes, please.

10 A On page 13 of Attachment 1, footnote 19, which
11 is working through a numerical example, the second
12 sentence should read "over 93 million residential lines,
13 the \$1.25 per line shortfall" instead of 75 cents. And
14 this example translates into an annual revenue shortfall
15 of 140 million instead of 84 million.

16 Q Dr. Schmalensee, you said 93 million. Did you
17 mean 9.3 million?

18 A Yes. Sorry about that.

19 The second correction occurs on page 16. In
20 the graph figure one, the rightmost bar which indicates
21 U.S. telecommunications output growth over the period
22 '90 to '93, that should be labeled 2.9 percent instead
23 of 2.6 percent. And thus, I suppose, although we
24 haven't done it, the graph should be redrawn so that
25 that rightmost bar is slightly above rather than being
26 slightly below the black bar that it touches.

27 The third correction is on page 22 of
28 Attachment 1. The second complete paragraph on that

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1 page, the second to the last sentence, which begins "in
2 fact" should continue "in fact, output growth has been
3 decreasing." The word "growth" was inadvertently
4 omitted after "output."

5 I have one more. On page 23, footnote 41
6 should read "The UCLA business forecast for the nation
7 and California, December 1994."

8 Those are the corrections.

9 Q With those corrections do you adopt Exhibit 1
10 as your prepared testimony in this proceeding?

11 A I do.

12 Q Turning to Exhibit 2 for identification, do
13 you have a copy of that document before you?

14 A Yes, I do.

15 Q And was Exhibit 2 prepared by you or under
16 your direction?

17 A Yes, it was.

18 Q Do you have any additions or corrections to
19 Exhibit 2?

20 A No, I do not.

21 Q Do you adopt Exhibit 2 as your prepared reply
22 testimony in this proceeding?

23 A I do.

24 MR. SASSER: Your Honor, I would move the admission
25 of Exhibits 1 and 2.

26 ALJ REED: We will wait until after
27 cross-examination.

28 Mr. Sasser.

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1 MR. SASSER: Dr. Schmalensee is available for
2 cross-examination.

3 ALJ REED: Thank you.

4 Mr. Faber.

5 MR. FABER: Thank you, your Honor.

6 CROSS-EXAMINATION

7 BY MR. FABER:

8 Q Good morning, Dr. Schmalensee. My name is Joe
9 Faber. I am counsel for the California Committee for
10 Large Telecommunications Consumers. I am going to ask
11 you some questions that go to your two exhibits as well
12 as several more general questions.

13 Let's start, however, with Exhibit 1, which is
14 your prepared testimony of September the 8th. Do you
15 have that in front of you?

16 A Yes, I do.

17 Q The questions that I am going to ask, just so
18 you understand, go to the attachment, the prepared
19 report called "Incentive Regulation and Competition
20 Issues for the 1995 Incentive Regulation Review." Could
21 you turn to that.

22 A Yes.

23 Q It is indicated on that document that it was
24 prepared by you and two other gentlemen, a
25 Timothy J. Tardiff and a William A. Taylor?

26 A Yes.

27 Q Could you tell us who Mr. Tardiff is?

28 A Mr. Tardiff is -- I am not sure I know his

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1 rank. He is I think a vice president in National

2 Economic Research Associates.

3 Q Do you work with him regularly on economic
4 matters?

5 A I don't know how -- what you would consider
6 fairly regularly. I do work with him on economic
7 matters.

8 Q Has he worked with you to prepare testimony in
9 any other jurisdiction besides California prior to this?

10 A He has worked with me. I am not sure that any
11 other testimony has been filed with both our names on
12 it, but I have worked with him on other testimony.

13 Q Who is Mr. Taylor?

14 A Mr. Taylor is also with National Economic
15 Research Associates. I believe he is a senior vice
16 president.

17 Q And similarly, you worked with Mr. Taylor
18 before on economic issues?

19 A Yes.

20 Q Have you worked with him to prepare testimony
21 in any other jurisdiction?

22 A Yes.

23 Q Are you familiar with the history of the prior
24 NRF review proceeding that this Commission held back in
25 the earlier 1990's?

26 A Broadly familiar, not in detail.

27 Q You are aware that William Taylor was a
28 witness in that proceeding, is that right?

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1 A Yes.

2 Q Are you familiar at all with the testimony he
3 submitted in that case?

4 A I believe I have read it, yes.

5 Q Did you help him prepare any of that
6 testimony?

7 A No.

8 Q Did you discuss with Mr. Tardiff or Mr. Taylor
9 whether one of them ought to be testifying here instead
10 of you in this case since you all prepared the report?

11 A I don't believe we had such a discussion, no.
12 I think it was understood from the start of the
13 assignment that I would probably be testifying.

14 Q Who prepared the first draft of the attachment
15 to Exhibit 1?

16 A My understanding is that Tim prepared it,
17 although Bill may have been involved. In any case, I
18 received a first draft from Tim.

19 Q When Mr. Sasser questioned you, you stated
20 that this document was prepared either by you or under
21 your direction, that you answered yes to that question.
22 Do you recall that?

23 A Yes.

24 Q Can you tell us what portions of Attachment 1
25 you prepared?

26 A I reviewed several earlier drafts. I made
27 suggestions. I could probably find sentences that I
28 wrote, but I certainly went through the arguments in

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1 several earlier drafts.

2 Q There are various items of economic data. You
3 corrected one, for example, on page 16 regarding output
4 growth rates. Did you gather any of the economic data
5 that is included in this report?

6 A No. I think those data were primarily gathered
7 by NERA staff in this case under the supervision of
8 Drs. Tardiff and Taylor.]

9 Q Now, have you worked with other people at NERA
10 besides Dr. Tardiff and Taylor in preparing testimony?

11 A Yes.

12 Q Have you ever submitted testimony in other
13 state jurisdictions besides this state in which there
14 were other names on the testimony beside yours?

15 A Yes.

16 Q And on those occasions, did you follow the
17 same pattern, that is, someone else prepared a draft for
18 you and you reviewed it and commented on it?

19 A There's variation from case to case, but
20 that's generally been the pattern.

21 Normally, preceding the preparation of the
22 draft is a discussion of the issues and the general
23 framework involved, but broadly similar patterns, yes.

24 Q Now, let's turn for a moment to the attachment
25 to Exhibit 2. This was a report entitled "Incentive
26 Regulation and Competition Reply Comments Dated
27 September the 18th."

28 Do you have that in front of you?

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1 A Yes, I do.

2 Q Was that also handled in the same manner as
3 far as preparation of a first draft?

4 A The first draft that I was given was by
5 Dr. Tardiff, that's correct.

6 Q And, again, did you provide comments and
7 suggestions on revising this so that it could be
8 submitted to this Commission?

9 A Yes.

10 Q Are there any particular sections of the
11 attachment to Exhibit 2 that you drafted yourself?

12 A There aren't any for which I did the initial
13 drafting, no.

14 Q Now, you mentioned in response to my question
15 that you had read Dr. Taylor's testimony in the last NRF
16 proceeding; is that right?

17 A Yes.

18 Q Do you recall generally that he testified at
19 that time that NRF, in his opinion, was working fine and
20 that there was no need to modify the productivity factor
21 in the price caps formula?

22 A I didn't read his cross-examination. I read
23 his prepared testimony, and that's consistent with the
24 crux of his prepared testimony, yes.

25 Q I take it you are generally familiar with
26 price cap regulation and the new regulatory framework in
27 California; is that right?

28 A Generally familiar. I don't know all the

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1 details.

2 Q Would you agree that one of the key purposes
3 of the price cap formula is to track the anticipated
4 growth of LEC costs based upon industry-wide conditions
5 as opposed to tracking company-specific costs?

6 A Well, the price cap structure is
7 forward-looking. So you said anticipating, and
8 that's -- that's correct. It is generally aimed at
9 using industry-wide information to provide reasonable
10 estimates for a company's particular situation.

11 But, again, I don't know the details of the
12 language, but if a price cap regime completely
13 disregards important aspects of an individual company
14 situation, it is plainly not viable.

15 Q I'm not -- let me be clear. I'm not trying to
16 confuse you or trick you as to the language the
17 Commission used in setting up its NRF, I'm just talking
18 about the concept. The concept of price cap regulation
19 is to look -- somehow forecast the anticipated rate of
20 growth of the regulated company's costs in order to
21 allow it to adjust its rates. And it does that on the
22 basis of industry-wide data not company-specific data;
23 isn't that right?

24 A My only qualification is that it obviously
25 uses large industry-wide data, but I'm just offering the
26 information one needs to pay attention to to reasonably
27 anticipate the differences between the company and the
28 rest of the industry which is nonetheless consistent

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1 with the performance.

2 Q Looking at the California plan, isn't it fair
3 to say that the rate of growth of the LEC costs under
4 that formula is expected to be lower than that of the
5 economy-wide inflation rate because the LECs as an
6 industry, have been understood to be achieving greater
7 productivity than the economy as a whole; is that
8 right?

9 A The rate of growth of prices specified under
10 that is anticipated to be less than the economy-wide
11 rate of growth of inflation because LEC productivity has
12 historically been -- is anticipated to be greater than
13 average, that's correct -- productivity growth.

14 Q But the reason that the prices are being
15 adjusted, under the price-cap formula, is because the
16 price-cap formula is supposed to be recognizing that the
17 costs to the LECs are increasing at some rate; isn't
18 that right?

19 A That's correct, yes.

20 Q Would you agree that the purpose of the
21 X factor in the price cap formula is to capture the
22 difference in the growth of industry-wide LEC costs
23 vis-a-vis the growth of economy wide costs?

24 A Well, I need to -- this is essentially related
25 to one of your earlier questions. And, as I say, I
26 don't know what was in the minds of the drafters, but it
27 seems to me as an economic matter, one needs to take
28 into account anticipatable differences between company

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1 performance and industry-wide performance as long as
2 those differences are consistent with efficient behavior
3 so that there are reasons to think that going forward
4 there will be differences associated with differences in
5 output growth or whatever, I should think those would be
6 taken into account. I don't know what was in the minds
7 of the framers of the California plan.

8 Q But with that caveat, that you need to
9 consider unique circumstances associated with specific
10 companies, would you agree with my statement about the
11 purposes of the X factor in the price cap formula?

12 A I need to hear it again; I'm sorry.

13 Q All right. The question was, would you agree
14 that the purpose of the X factor in the price cap
15 formula is to capture the difference in the growth of
16 industry-wide LEC costs vis-a-vis the growth of
17 economy-wide costs?

18 A With the qualification -- and my qualification
19 is a rather important one because it -- it says -- it
20 would rather modify your statement to relying heavily on
21 industry-wide data and using the industry as a
22 yardstick -- the ultimate aim is to provide an X factor
23 that is reasonably consistent with efficient and
24 attainable productivity growth in a company on which you
25 focus. To say that one ought simply to design the X
26 factor without any idle or local conditions, I think,
27 doesn't make economic sense.

28 Q So when the Commission establishes an X factor

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1 in the price cap formula, be it when it started NRF in
2 1990 or when it reviewed NRF in the early '90s or when
3 it's reviewing NRF now, it ought to be looking at the
4 relevant productivity data of the individual LECs that
5 are subject to the price cap regulation?

6 A No, let me be clear. It ought to be looking
7 at factors likely to affect the productivity of
8 individual LECs.

9 The reason for using industry-wide data is in
10 large part to break the link -- the tying link between a
11 company's own costs and its own prices that existed
12 under rate of return, use industry-wide data to break
13 that.

14 But you can't rely wholly on information
15 outside of California to decide what's reasonable within
16 California. You don't extrapolate the company's own
17 performance; but it seems to me, as Pacific has
18 proposed, that one ought to take into account factors
19 outside the company likely to affect its efficiency.

20 Q Now, if we focus just on the costs facing LECs
21 for a moment, there could be any number of reasons why
22 the rate of increase in costs facing LECs might be
23 slower than the rate of increase in economy-wide costs;
24 isn't that right?

25 A That's correct.

26 Q Let me ask you to assume for the sake of this
27 question that the growth rate of the prices of inputs to
28 the LEC's production processes happen to be slower than

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1 the growth rate of prices of production inputs for the
2 economy generally.

3 Do you have that assumption in mind?]

4 A I have that assumption in mind.

5 Q All other things being equal, if that
6 assumption is true, would you agree that the costs to
7 the LEC industry would tend to increase more slowly than
8 the economy-wide inflation rate?

9 A All else equal, it's a matter of either
10 elementary accounting or elementary economics. It's
11 correct. It would increase -- costs would increase less
12 rapidly.

13 Q And in fact -- and, again, holding all else
14 constant, the extent to which the growth in LEC costs
15 deviates from the economy-wide inflation rate will be
16 essentially the same as the extent to which the rate of
17 growth in LEC input prices differs from the rate of
18 growth in economy-wide input prices; isn't that right?

19 A I am assuming, of course, in your "all else
20 equal" that underlying changes in total factor
21 productivity are the same in the LECs as in the economy.

22 Q Yes.

23 A And under those circumstances rates of cost
24 change are driven by rates of input-price change as you
25 suggest.

26 Q You anticipated my next question.

27 So that statement would hold true, assuming
28 that the LEC productivity growth rate were no better

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1 than the overall rate of productivity growth in the
2 economy; correct?

3 A I'm sorry. Which statement, now, precisely?

4 Q The statement that the extent -- well, let me
5 back up and get this really clear because I want to make
6 sure that this point is straight on the record.

7 I asked you whether, if we held everything
8 constant, the extent to which LEC costs deviate from the
9 economy-wide inflation rate will be essentially the same
10 as the -- I'm sorry. Let me start again.

11 You agreed with me, I think -- and you can
12 correct me if I'm wrong -- that the extent to which the
13 growth in LEC costs deviates from the economy-wide
14 inflation rate will be exactly or essentially the same
15 as the extent to which the rate of growth in LEC input
16 prices differs from the rate of growth in economy-wide
17 input prices, if everything else was held constant; is
18 that right?

19 A As I think both Dr. Christensen and I say in
20 our prepared testimony, is consistent with our prepared
21 testimony on this point, and assuming under your
22 "everything else constant," you mean growth in Total
23 Factor Productivity is the same in the LECs as in the
24 rest of the economy, then cost changes driven by in- --
25 is driven by input price change.

26 Q Now, as I understand it, you disagree with
27 Dr. Selwyn's view that there's a difference between the
28 rate of growth in LEC input prices and the rate of

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1 growth in economy-wide input prices; is that right?

2 A That's right. It would be.

3 And, to be more precise, I don't believe that
4 the existing data allow one to measure or to detect any
5 such difference, if it exists, and they are certainly at
6 this stage more consistent with its nonexistence than
7 with its existence.

8 Q So your disagreement goes to the factual
9 question of whether such an input-price-growth deviation
10 exists; is that right?

11 A That's correct.

12 Q Would you agree that in the real world, inputs
13 are not necessarily homogenous?

14 A As a general matter, almost a -- a perfect
15 identity is rare, so I think that's got to be right.

16 But you mean homogenous within industry as
17 across industry, I'm not sure what context we have here
18 of --

19 Q I'm actually interested here in
20 cross industries.

21 A Different industries tend to use different
22 input mixes; that's correct.

23 Q And also inputs are not perfectly
24 substitutable for one another; isn't that right?

25 A I'm not sure what inputs you have in mind
26 now. No two people are perfect substitutes. So I'm
27 not --

28 Q Well, the inputs that go into a -- into one

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1 industry, for example, the telecommunications industry,
2 are different from the inputs that go into, say, the
3 health-care industry; isn't that right?

4 A (Indicating) In some respects. Certainly the
5 mixture of inputs is different.

6 Q In some cases certain of the inputs would be
7 substitutable between one industry and another; isn't
8 that right?

9 A Yes.

10 Q Now, is there a basic principle of economic
11 theory that would suggest that over time the prices for
12 a particular input used in different sectors of the
13 economy would tend to grow at the same rate, assuming
14 that the input was relatively homogenous?

15 A Assuming that the input is freely employable
16 in both sectors, that is to say, it can move from one to
17 the other -- and this in many cases amounts to assuming
18 away unions for labor inputs -- one expects one price to
19 prevail in the market for a homogeneous product.

20 I would note, however, that the labor
21 economics literature and other literature show strong
22 differences between industries and the apparent -- in
23 the compensation for apparently identical (indicating)
24 substitutable individuals.

25 So with that caveat, that there are often
26 market imperfections, one expects one price to prevail
27 in a market.

28 Q If the contrary was true, that is, that a